Touchstone Investments®
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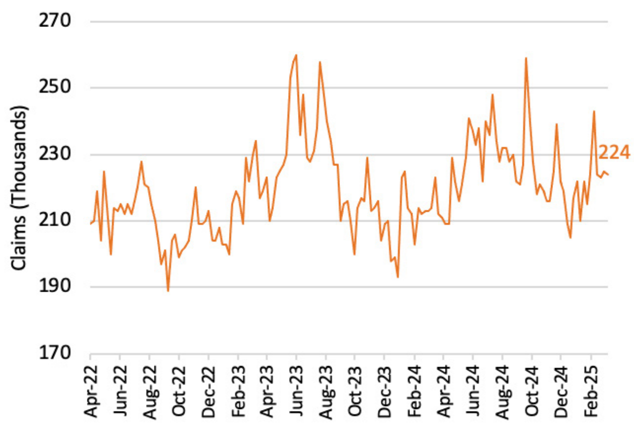
Fixed Income:
Economic Backdrop

Authors: Crit Thomas, CFA, CAIA / Erik M. Aarts, CIMA / Brian Cheyne, CFA, CIMA

April 2, 2025

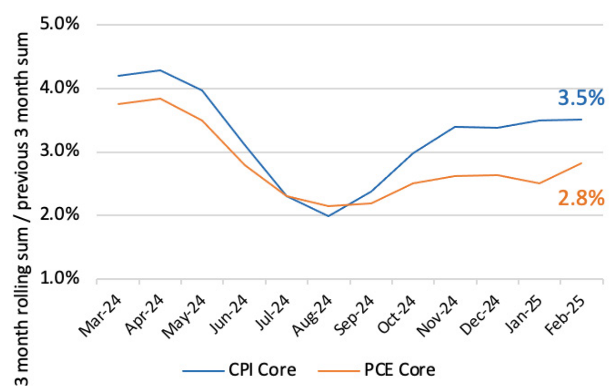
- **Softer Landing:** Economic uncertainty fueled by government policy has negatively impacted sentiment and is beginning to creep into the hard data, such as consumer spending. While our baseline scenario continues to forecast a soft landing for the U.S. economy, the likelihood of a more turbulent landing is increasing. Accordingly, we have dialed back pro-cyclical risks in our asset allocation models.
- **Liberation Day:** Recent tariff announcements are unlikely to clarify or mitigate economic uncertainty, as they appear to be part of ongoing bilateral trade negotiations. The Trump administration has acknowledged that their aggressive policy actions are likely to create near term pain.
- **Labor Market Signal:** Despite concerns about government related job losses extending into the private sector, initial unemployment claims remain low and stable. A solid job market is very important to sustaining consumer spending, so we are watching the labor market closely.
- **Stagflation:** The combination of slowing growth, rising unemployment, and increasing inflation defines stagflation, a rare but challenging economic condition to manage with conventional policy tools. We anticipate that concerns about stagflation will intensify under the current conditions.
- **Remain Calm:** We remain in the soft-landing camp because businesses are still financially strong. Corporate balance sheets are strong, and profit margins remain high. Consumers are also generally in good shape given low unemployment, good real wage growth and low debt burdens.
- **Secular Transformation:** Restructuring an economy takes a long time. Returning manufacturing to the U.S. will require expanding capacity which will take years to build and be expensive. Deglobalization is inherently inflationary. We believe inflation remains sticky and recognize the potential for additional waves of higher inflation down the road.

US Initial Jobless Claims



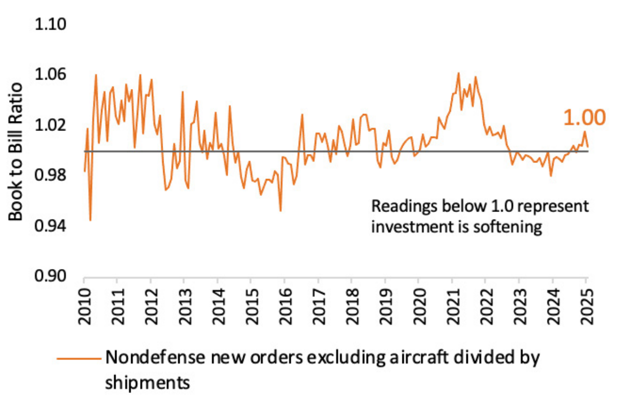
Source: Bloomberg. 3 years of weekly data through Mar 21 2025

Core Inflation Q/Q annualized



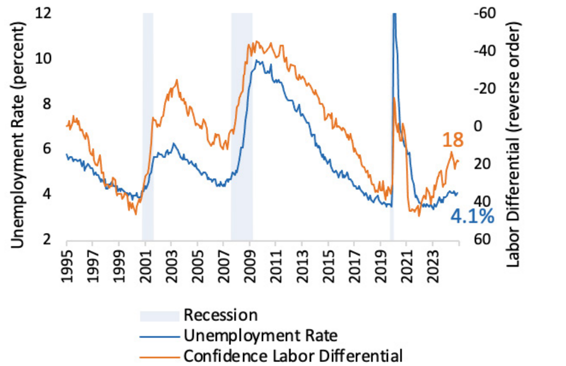
Source: Bloomberg. 1 year of monthly data through Feb 2025

Capital Goods Book to Bill Ratio



Source: Bloomberg. 15 years of monthly data through Feb 2025

Employment Trends



The conference Board Consumer Labor Differential measures the difference between the percent of consumers responding jobs were plentiful versus those responding they were hard to get.

Source: Bloomberg. 30 years of monthly data through Mar 2025, Unemployment through Feb 2025

Fixed Income:

Interest Rate Risk

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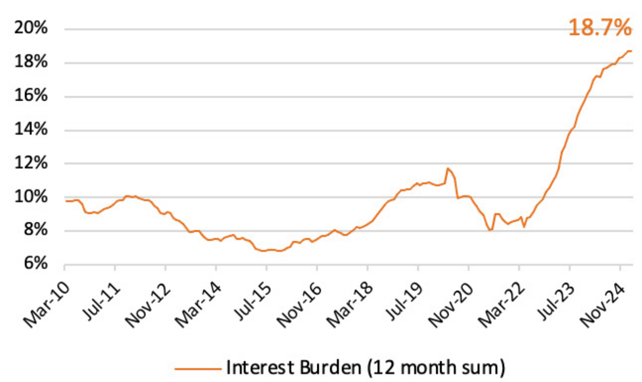
- **Higher Quality:** We tactically increased our investment grade bond exposure, shifting to a slight overweight, to mitigate overall risk in our models. High quality fixed income presents an appealing risk-adjusted return potential, characterized by attractive yields and lower economic sensitivity.
- **Duration Neutral:** We adjusted to a neutral duration stance, as we believe interest rate risks are now more balanced. The prospect for slower growth could put downside pressure on yields, while sticky inflation and ongoing government budget negotiations could drive yields higher.
- **Continuing Resolution:** Congress passed a bill to continue spending at current levels through September, averting a government shutdown. The temporary measure provides a brief window to negotiate a deal which may include significant cuts to entitlements coupled with an extension of the 2017 tax cuts. We anticipate reliance on accounting maneuvers and optimistic economic forecasts to project fiscal prudence, though we expect the Treasury market to see through such strategies.
- **Unsustainable Debt:** The nonpartisan Congressional Budget Office has updated its long-term budget outlook, forecasting significant, ongoing deficits that elevate the country's debt-to-GDP ratio to historic levels by 2029. The projections assume the expiration of the TCJA tax cuts. The outlook underscores an unsustainable debt trajectory, increasing pressure on Congress to enact a more balanced budget.
- **Monetary Policy Pause:** The Fed is on hold, forecasting lower economic growth and higher core inflation by year end. The committee did agree to slow the pace of reduction of Treasury holdings on their balance sheet which may help support Treasury yields in the near term. We believe the Fed remains in easing mode but may not be ready to adjust rates again until they have more clarity on the economic impact of the administration's trade policies.
- **Yield Cushion:** The relative return potential for high quality, intermediate maturity fixed income has improved, supported by attractive starting yields. Should economic risk intensify we would expect the asset class to provide valuable diversification.

U.S. Government Securities Liquidity Index

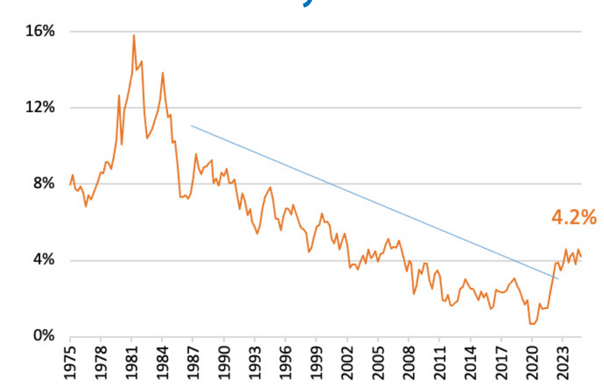
Source: Bloomberg. 10 years of weekly data through Mar 30 2025. The Liquidity Index as calculated by Bloomberg measures prevailing liquidity conditions in the U.S. Treasury market based on intra-day yield dislocations from fair value.

U.S. Budget Interest Expense/Total Revenues



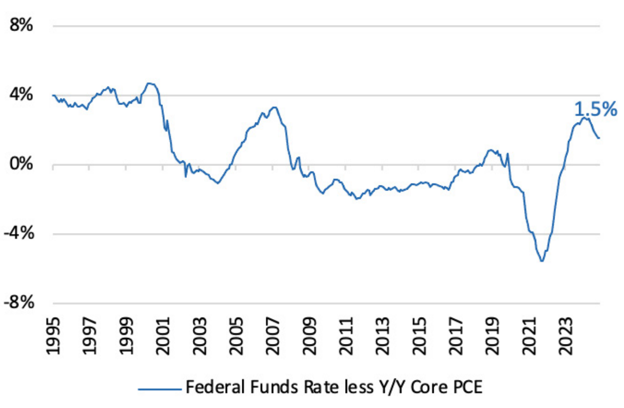
Source: Bloomberg. Annual data from fiscal 1974 through 2024 Feb 2025

10 Year U.S. Treasury Yield



Source: Bloomberg. 50 years of quarterly data as of Mar 2025

Real Federal Funds Rate



Source: Bloomberg. 30 years of monthly data through Feb 2025

Fixed Income:

Credit Risk

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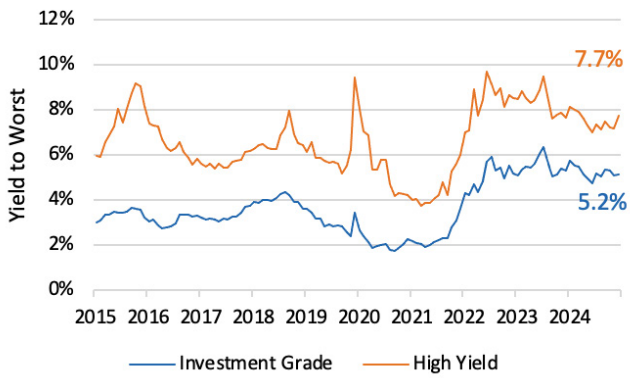
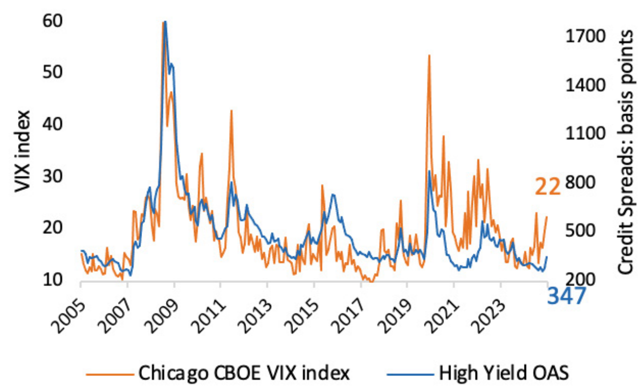
- **Cautious on Credit:** We reduced our exposure to non-investment grade bonds, shifting to a slight underweight from a slight overweight to trim pro-cyclical risk.
- **Spreads Resilient:** Despite adverse economic news and negative sentiment, spreads across corporate and securitized credit have widened only marginally. Spreads in both investment grade and high yield corporate sectors remain below the peaks observed last summer. Similarly, investment-grade securitized credit spreads have remained stable since the beginning of the year.
- **What to Watch:** There is potential for further widening of spreads amidst this period of policy uncertainty. With the onset of the earnings reporting season, we will closely monitor any shifts in corporate spending plans, increases in layoff announcements, and changes in forward earnings guidance.
- **Strategic Allocation:** We continue to endorse the inclusion of high yield debt within diversified portfolios that encompass stocks and bonds, aiming to enhance the return potential of fixed income while providing downside protection relative to equities.
- **Stay Nimble:** As businesses remain financially strong, we expect any improvement in relative value may tempt investors, armed with plenty of dry powder, back into the credit markets at spread levels narrower than in previous cycles.
- **Active Management Required:** The present market conditions are expected to distinctly separate winners from losers, offering opportunities to generate returns and manage risks effectively. We remain committed to adapting our tactical credit allocations in response to evolving market dynamics.

Bloomberg U.S. Corporate Bond Indexes



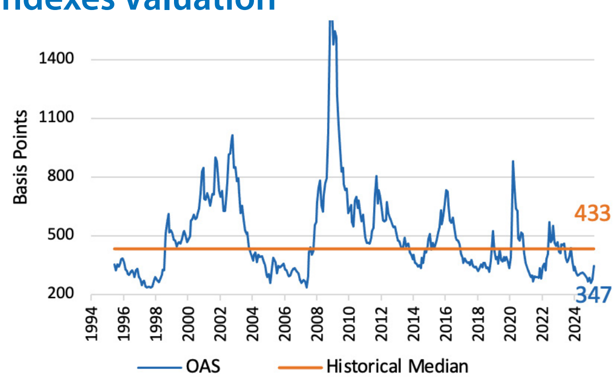
Source: Bloomberg. 10 years of monthly data through Mar 2025

Credit Spread versus Implied Stock Volatility



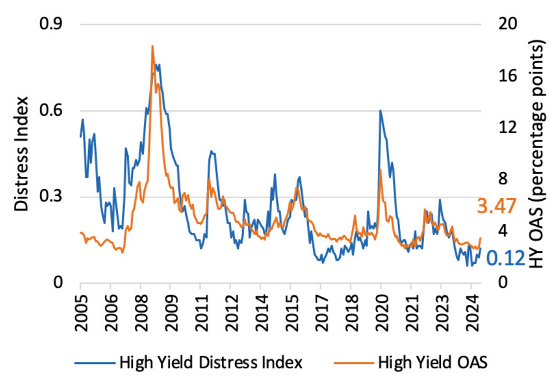
Source: Bloomberg. 20 years of monthly data through Mar 2025

Bloomberg U.S. Corporate High Yield Indexes Valuation



Source: Bloomberg. 30 years of monthly data through Mar 2025. Last observation percentile 28%

NY Fed Corporate Bond Distress Index



Source: Bloomberg. 20 years of monthly data through Mar 2025

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Fixed Income:
Market Characteristics

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The Indexes mentioned are unmanaged statistical composites of stock market or bond market performance. Investing in an index is not possible.

Total Returns

	March 2025	YTD	2024	2023	2022	Duration years
Bloomberg Long Term Treasury	-0.9%	4.7%	-6.4%	3.1%	-29.3%	14.9
Bloomberg U.S. TIPS	0.6%	4.2%	1.8%	3.9%	-11.8%	4.9
Bloomberg U.S. Aggregate	0.0%	2.8%	1.3%	5.5%	-13.0%	6.1
Bloomberg U.S. Agg Corporate	-0.3%	2.3%	2.1%	8.5%	-15.8%	6.9
Bloomberg U.S. Agg ABS	0.2%	1.5%	5.0%	5.5%	-4.3%	2.6
Bloomberg U.S. Agg MBS	0.0%	3.1%	1.2%	5.0%	-11.8%	5.9
Bloomberg U.S. Agg CMBS	0.3%	2.6%	4.7%	5.4%	-10.9%	4.1
Bloomberg Municipal Bond	-1.7%	-0.2%	1.1%	6.4%	-8.5%	6.5
Bloomberg 1-3 year Corporate	0.4%	1.6%	5.3%	5.5%	-3.3%	1.9
ICE BofA Listed Preferreds	-3.1%	-1.7%	8.5%	9.8%	-18.1%	NA
Bloomberg High Yield	-1.0%	1.0%	8.2%	13.4%	-11.2%	3.1
Credit Suisse Leveraged Loan (discount margin)	-0.3%	0.6%	9.1%	13.0%	-1.1%	NA
Bloomberg Global Agg	0.6%	2.6%	-1.7%	5.7%	-16.2%	6.5
Bloomberg Emerging Markets USD	-0.4%	2.3%	6.6%	9.1%	-15.3%	6.0

Yields

			Last 10 years			
	March 2025	YTD Change bps	Current Percentile	Median	Min	Max
10 year Treasury	4.2%	-36	88	2.4%	0.5%	5.0%
2 year Treasury	3.9%	-36	76	1.6%	0.1%	5.2%
10 year TIPS	1.8%	-39	88	0.5%	-1.2%	2.5%
Bloomberg U.S. Aggregate	4.6%	-31	81	2.6%	1.0%	5.7%
Bloomberg U.S. Agg Corporate	5.2%	-18	80	3.4%	1.7%	6.4%
Bloomberg U.S. Agg ABS	4.6%	-15	76	2.1%	0.4%	6.0%
Bloomberg U.S. Agg MBS	4.9%	-35	86	2.9%	0.9%	6.1%
Bloomberg U.S. Agg CMBS	4.9%	-31	77	2.9%	1.4%	6.6%
Bloomberg Municipal Bond	3.8%	11	95	2.3%	0.9%	4.5%
Bloomberg 1-3 year Corporate	4.6%	-24	76	2.2%	0.5%	6.2%
Bloomberg High Yield	7.7%	24	73	6.5%	3.5%	11.7%
Credit Suisse Leveraged Loan (discount margin)	8.6%	-21	78	5.7%	3.6%	13.1%
Bloomberg Global Agg	3.6%	-6	82	1.7%	0.8%	4.4%
Bloomberg Emerging Markets USD	6.5%	-18	73	5.3%	3.5%	8.7%

Option Adjusted Spreads (bps)

			Last 10 years			
	March 2025	YTD Change	Current Percentile	Median	Min	Max
Bloomberg U.S. Corporate Agg	94	14	23	118	74	373
Bloomberg 1-3 year Corporate	58	6	44	62	31	390
Bloomberg U.S. Agg ABS	60	16	64	52	22	325
Bloomberg U.S. Agg MBS	36	-7	49	34	7	132
Bloomberg U.S. Agg CMBS	88	8	53	93	62	275
Bloomberg High Yield	347	60	32	379	253	1100
Credit Suisse Leveraged Loan (discount margin)	498	23	49	495	379	1275
Bloomberg Emerging Markets USD	236	16	8	307	205	720

For Index Definitions see: TouchstoneInvestments.com/insights/investment-terms-and-index-definitions

2022 – The Fed embarked on one of its most aggressive tightening paths seen in decades as the inflation rate surged well above their goal. Interest rates rose across all maturities leading to one of the worst years for fixed income returns.

2023 – Inflation fell broadly while the economy grew with the labor market and consumer spending resilient. The Fed paused midyear helping rates and credit spreads fall late in the year and turning returns positive for the year.

2024 – Economic growth continued unabated, driven by consumer spending. Inflation moderated further. The Federal Reserve pause continued until September, after which it cut interest rates three times by a total of 1 percentage point. Bond yields rose in response, resulting in only modest gains for high quality fixed income but better returns for riskier areas of fixed income.

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The Touchstone Asset Allocation Committee (TAAC) consisting of Crit Thomas, CFA, CAIA – Global Market Strategist, Erik M. Aarts, CIMA – Vice President and Senior Fixed Income Strategist, and Brian Cheyne, CFA, CIMA – Senior Investment Strategy Specialist, develops in-depth asset allocation guidance using established and evolving methodologies, inputs and analysis and communicates its methods, findings and guidance to stakeholders. TAAC uses different approaches in its development of Strategic Allocation and Tactical Allocation that are designed to add value for financial professionals and their clients. TAAC meets regularly to assess market conditions and conducts deep dive analyses on specific asset classes which are delivered via the Asset Allocation Summary document. Please contact your Touchstone representative or call 800.638.8194 for more information.

A Word About Risk

Investing in fixed-income securities which can experience reduced liquidity during certain market events, lose their value as interest rates rise and are subject to credit risk which is the risk of deterioration in the financial condition of an issuer and/or general economic conditions that can cause the issuer to not make timely payments of principal and interest also causing the securities to decline in value and an investor can lose principal. When interest rates rise, the price of debt securities generally falls. Longer term securities are generally more volatile. Investment grade debt securities which may be downgraded by a Nationally Recognized Statistical Rating Organization (NRSRO) to below investment grade status. U.S. government agency securities which are neither issued nor guaranteed by the U.S. Treasury and are not guaranteed against price movements due to changing interest rates. Mortgage-backed securities and asset-backed securities are subject to the risks of prepayment, defaults, changing interest rates and at times, the financial condition of the issuer. Foreign securities carry the associated risks of economic and political instability, market liquidity, currency volatility and accounting standards that differ from those of U.S. markets and may offer less protection to investors. Emerging markets securities which are more likely to experience turmoil or rapid changes in market or economic conditions than developed countries.

Performance data quoted represents past performance, which is no guarantee of future results. The investment return and principal value of an investment in the Fund will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than performance data given. ***For performance information current to the most recent month-end, visit TouchstoneInvestments.com/mutual-funds.***

Please consider the investment objectives, risks, charges and expenses of a fund carefully before investing. The prospectus and the summary prospectus contain this and other information about a fund. To obtain a prospectus or a summary prospectus, contact your financial professional or download and/or request one at TouchstoneInvestments.com/resources or call Touchstone at 800.638.8194. Please read the prospectus and/or summary prospectus carefully before investing.